2017 Review of the Rail Guidelines for Access Regimes

23 February 2017

2017 Review of the Rail Guidelines for Access Regimes

Introduction

Aurizon transports more than 250 million tonnes of Australian commodities, connecting miners, primary producers, and industry with International and domestic markets. It provides customers with integrated freight and logistics solutions across an extensive national rail and road network, traversing Australia. As such Aurizon is well placed to offer competitive rail services to promote efficiency and the interests of businesses and consumers within South Australia.

Presently, Aurizon's operations within South Australia are limited to interstate freight operations on the Australian Rail Track Corporation (**ARTC**) managed interstate rail network. Aurizon obtains below rail services from rail infrastructure managed by Genesee and Wyoming Australia (**GWA**) associated with these interstate freight operations. Notwithstanding, Aurizon envisages that it could become an access seeker with the objective of providing intrastate rail services within South Australia given the appropriate commercial circumstances and an access regime which supported a viable and effective rail haulage tender.

Aurizon welcomes the opportunity to make a submission to the Essential Services Commission of South Australia's (**ESCOSA**) review of the Information Kit[1] which relates to the South Australian Rail Access Regime (**SARAR**). This submission does not address matters relating to the Guidelines prepared for the Tarcoola-Darwin Access Regime. Nevertheless, Aurizon may contribute views to ESCOSA on these Guidelines during the consultation process in response to issues identified by other stakeholders or on further requests for comments by the regulator.

Aurizon acknowledges that:

> the objective of the Information Kit is to assist access seekers and the access provider in understanding the operation of the SARAR and the matters and principles the access provider needs to address to ensure compliance with the regime; and

> the scope of ESCOSA's review is limited to the content of the Information Kit and its consistency with the *Railways (Operations and Access) Act 1997 (***ROA Act**), and the review does not extend to a review of the SARAR itself.

The content of the Information Kit needs to achieve an appropriate balance in terms of meeting the objectives of the ROA Act and the costs associated with its application. As a principle, Aurizon supports effective regulation which is targeted towards advancing the relevant competition and efficiency objectives to the extent necessary. Consistent with this principle this submission is limited to improving the Information Kit to:

> clarify the scope and coverage of the regime to reduce regulatory risk and uncertainty;

---

[1] Essential Services Commission of South Australia (2010) Information Kit – South Australian Rail Access Regime, version 3.1, March

- improve the contestability of rail transport services through establishment of guidelines around the access charge which can be fairly asked; and
- strengthen the compliance arrangements to reduce the prospect for discrimination between the price and terms offered to an access seeker and those relevant to the access provider's related rail operations.

All references in this submission to the following terms are substituted for the relevant terms in the ROA Act:

- 'access provider' has the same meaning as 'operator'; and
- 'rail operator' has the same meaning as "industry participant'.

Clarity on scope and coverage of SARAR

The Information Kit currently notes the scope of the Access Regime was determined by Ministerial proclamation in May 1998. While Aurizon notes that it is inevitable that the scope and coverage of the regime will include some uncertainty as the use of some rail infrastructure is diverse and subject to change over time, an effective regulatory framework should minimise this uncertainty to the extent possible.

The proclamation reproduced in Appendix A of the Information Kit declares that:

> *All of the provisions of the access regime apply to any railway services associated with the provision (or the provision and operation) of any railway infrastructure by any operator.*

In isolation, this definition is reasonably clear and would indicate that all rail infrastructure within South Australia, including yards and sidings unrelated to a freight terminal, would be subject to the regime.

However, the scope of the access regime becomes uncertain through the relevant exclusions in the remainder of the proclamation. For example, the exemption in clause 2(a) relates to the Interstate Mainline Track as defined by the Railways Agreement set out in the schedule to the *Non-Metropolitan Railways (Transfer) Act 1997 (SA)*.

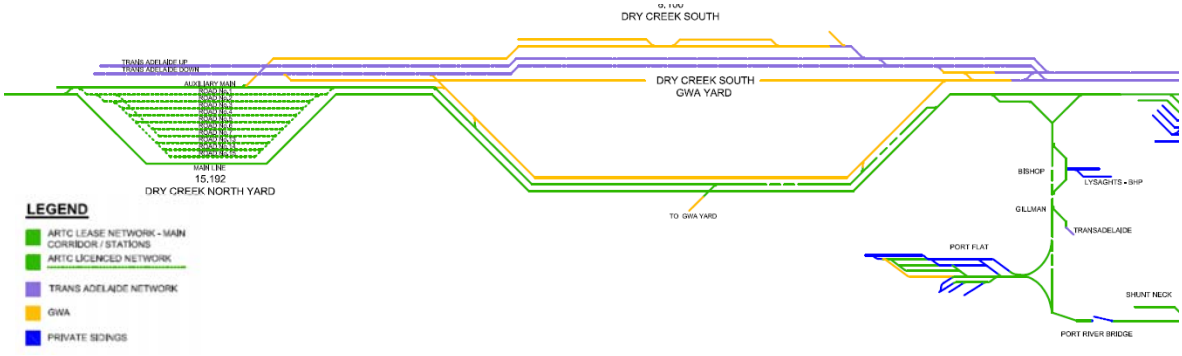
Schedule 3 of the *Non-Metropolitan Railways (Transfer) Act 1997* then refers to the rail infrastructure which is subject to a number of other agreements and acts. For example, this also includes the railway from Adelaide to the Victorian Border as outlined in *Adelaide to Nairne Railway Act 1878 (SA)* and the *Nairne to Victorian Border Railway Act 1882 (SA)*.

The exact nature of the rail infrastructure that is included within the Adelaide area in this act is not defined. However, having regard to the ownership diagrams produced by ARTC[2] for the East - West Corridor SA Network this would include all rail infrastructure owned by ARTC and licenced to GWA as shown in the selected extract in Figure 1.

The proclamation in clause 3 notes that despite clause 2(a), infrastructure including railway yards and sidings (including associated track structures, support, lines, post and signs) is accessible. This qualification would seem to suggest that all railway yards and sidings should be accessible.

[2] https://www.artc.com.au/library/ARTCS3090005_EW_SA.pdf

Figure 1. Extract from ARTC Ownership Map for South Australia



However, the Information Kit provides additional uncertainty by noting that some ARTC owned sidings in South Australia are managed under licence by Genesee & Wyoming Australia (GWA) and that:

> *ARTC obliges GWA to provide third party access to its licensed sidings on fair and reasonable terms. Access Seekers are advised to take those arrangements into account if seeking access to sidings licenced to GWA.*

Furthermore, in relation to sidings the definition of private siding in the *Rail Safety Act 1996 (SA)* differs from that in the Information Kit:

> *"**private siding**" means a siding owned and maintained by a person who does not own, control or manage the running line with which the siding connects or to which it has access, but does not include a marshalling yard or a passenger or freight terminal, or a siding of a kind excluded by the regulations from the ambit of this definition.*

Under this definition it is also feasible that any siding managed by an accredited railway manager may not be a private siding if it was excluded from the ambit of the definition.

The reliance on multiple legislative instruments and legacy agreements to define the scope of the access regime significantly impacts on the transparency and efficacy of the regime. It also increases the possibility that a potential access seeker would need to undertake a costly and protracted legal challenge to establish the right to negotiate access in accordance with the access regime.

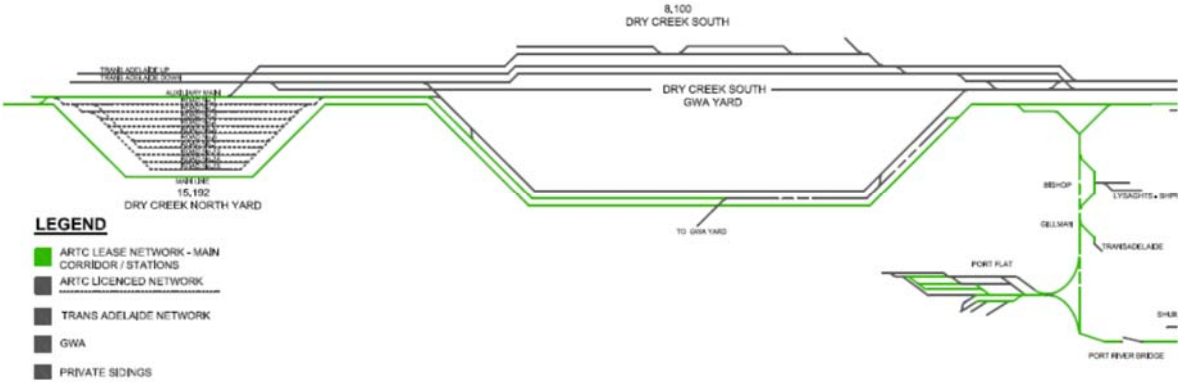
Aurizon considers that the coverage of the regime can be substantially clarified through the inclusion of line diagrams within the Information Kit which identify the scope of the access regime. The publication of line diagrams which represent the scope of the access regime is standard regulatory practice in other jurisdictions.

If an initial review identifies rail infrastructure which is subject to a licence agreement with ARTC to provide access on fair and reasonable terms is not covered due to the construction of the proclamation, then appropriate recommendations should be made to the relevant Minister to amend the proclamation to include those facilities.

The inclusion of these facilities within the scope of the regime is reasonable on the basis that without the licence arrangement those facilities would be included within the scope of the 2013 Interstate Access Undertaking (**2013 IAU**). As an example the Dry Creek North Yard is not included in the 2013 IAU as show in the line diagram at Figure 2 but is managed by GWA under licence from ARTC. The yard is also not directly accessible by mainline owned by GWA and the facility provides essential marshalling services for interstate freight services.

The exclusion of facilities such as the Dry Creek yard from either the 2013 IAU or the SARAR should not arise solely on the basis of a contractual arrangement between ARTC and GWA which is unable to be enforced by an access seeker. This provides one example of the uncertainty that arises from the original 1998 proclamation.

Figure 2. Extract from the Line Diagrams in 2013 Interstate Access Undertaking[3]



Guidance on a fair price of access

Aurizon has previously submitted to ESCOSA in its submission to the 2015 review of the SARAR that is was of the view that the Information Kit did not align to the requirements of the ROA Act in relation to the specification of a ceiling price in the pricing principles.

Clause 27(2) of the ROA Act states:

> *The floor price should reflect the lowest price at which the operator could provide the relevant services without incurring a loss and the ceiling price should reflect the highest price that could fairly be asked by an operator for provision of the relevant services.*

The Information Kit implies that the ceiling price should be based on the full economic cost of providing the relevant service as stated in para 3.2.1:

> *For the purposes of determining a ceiling price, the full economic cost of providing the relevant service prudently must be determined.*

Full economic cost under clause 3.2.1B includes a return on and of segment specific assets with reference to a regulatory asset value[4] which is to be based on a depreciated optimised replacement cost as specified under clause 3.2.4.

While full economic cost represents a relevant benchmark for the determination of the highest price that could be fairly asked, its application and relevance is strictly limited to markets and rail services which have the capacity to pay a price which covers the full economic cost of both the above and below rail service.

---

[3] http://www.artc.com.au/customers/access/access-interstate/network-configuration/library/ARTCS3090005_EW3_Undertaking_Jun%2015.pdf

[4] It is not known whether a regulatory asset value has been established in accordance with the requirements of the Information Kit.

Given the nature of the markets to which the SARAR applies and the competition objectives of the ROA Act, the ceiling price which could be fairly asked may also be that which is consistent with the vertically integrated rail provider's freight rate less its avoidable above rail costs. This would provide an access charge which maintains profitability of the regulated service but allows for competition and a potentially lower above rail price.

Aurizon is of the view that the Information Kit does not establish the principles or guidelines relevant to establishing the highest price which could be fairly asked by the access provider for the considerable majority of services which do, or could use, rail within South Australia.

Aurizon also notes that the principles of arbitration in the ROA Act requires the arbitrator to take into account the operator's legitimate business interests and investment in railway infrastructure. In this regard, full economic cost is likely to materially exceed the investment by the access provider in the railway. This investment would represent the implied value of the asset in the original purchase price and any subsequent investment not included in that original valuation. For example, the Economic Regulatory Authority of Western Australia's final report[5] on the 2014 review of the rail access code included reference to establishing an asset value which takes into account the investment made in rail infrastructure:

> *The Authority considers that establishing an opening depreciated value for all routes on the SW freight network is best established by the WA Government as owners/managers of the lease arrangement, because the lease contains the confidential provisions requiring performance and track standard reporting. The WA Government, as the original owner/lessor of the network, may have an owner's perspective of the history of the network and the value of individual routes at the time of the sale of the lease, and the changes in the value of network assets since the lease was entered into.*

As the principles of arbitration in Division 3 of the ROA Act include reference to the fixing of floor and ceiling prices specified in section 27 the establishment of those prices in accordance with the Information Kit may be relied upon by the arbitrator to establish the highest price that could be fairly asked. This may limit the arbitrator's ability to determine a price less than full economic cost.

In most circumstances the highest price that could be fairly asked by an access provider must be consistent with the competition objectives of the ROA Act. This may require access prices, subject to the floor limit, being competitively neutral which is defined by King and Gans[6] as being:

> *Competitive neutrality will hold when, for a given number of firms in the downstream market, the behaviour of the integrated firm in the downstream market does not differ from that of its competitors solely on the basis of its integration. That is, the regulated upstream facility's ownership could be transferred to any downstream competitor (or an independent owner) without any resulting change in behaviour in the downstream market.*

---

[5] Economic Regulation Authority of Western Australia (2015) Final Report on 2014 Review of the Railways (Access) Code 2000, December, p. 18.

[6] Gans, J.S. and King, S.P. (2005) Competitive Neutrality in Access Pricing, *The Australian Economic Review*, vol. 38, No. 2 p. 129.

This condition would effectively limit the price that could be reasonable asked as being one that would allow the related operator to profitably sustain operations if it wasn't also the owner of the below rail service. On balance, the highest price that could be fairly asked, taking into account the access provider's investment in the facility, would necessarily permit the entry of an efficient rail operator. This avoids the prospect of margin squeeze as stated by the European Commission and referenced in Jullien et al.[7]:

> *A dominant [access provider] may charge a price for access on the upstream market which compared to the price it charges for the downstream market, does not allow even an equally efficient competitor to trade profitability in the downstream market on a lasting basis.*

Aurizon recommends that the Information Kit be modified to include the principle of competitive neutrality as a matter relevant to the ceiling price.

The role and need for internal access charges

The role of a fair price is also relevant to the ensuring the access provider does not favour the operations of a related operator. This is a requirement of clause 23 of the ROA Act which requires:

> *An operator must not unfairly discriminate between the proponents in preferring one access proposal to another.*
>
> ***Example** –*
>
> > *If, for example, proponents A and B make access proposals to the operator, and both A and the operator are subsidiaries of the same holding company , it would be unfair discrimination for the operator to prefer A's access proposal on the basis of the relationship between them. It would also be unfair discrimination to prefer A's access proposal on the basis of price if B offers a **fair price** and the higher price offered by A is merely a transfer-pricing arrangement transferring profits from one part of a corporate group to another.*

There are two points of relevance in this example:

1. It is consistent with the view in the previous section that a fair price is not consistent with full economic cost. If this were the case it would necessarily require the higher price offered by the related operator to exceed the ceiling limit; and
2. It makes explicit reference to a price for access between the access provider and its related operator.

This is also consistent with the principles of arbitration which requires the arbitrator to have regard to:

> *The price of comparable services for other industry participants (including – if applicable – the operator itself)*

[7] Jullien, B., Rey, P. and Saavedrax, C. (2013) The Economics of Margin Squeeze, IDEI Report, October, p.4

Where the access provider and the rail operator are the same legal entity this necessarily requires the establishment of unbundled internal access charges in order to satisfy the requirement of a price for access provided by the operator to itself. However, it is not clear from ESCOSA's ten year review of revenues for Darwin to Tarcoola whether the access provider is maintaining internal access charges. In this regard, the KPMG audit report[8] stated in relation to intracompany revenues:

> *In the absence of a separate access charge to certain customers, both the interstate and the intrastate railways attribute part of the revenues they receive from those parties, to below rail services for the purposes of reporting to ESCOSA. These attributions are made on the basis of structured, customer specific charges and revenues.*
>
> *KPMG has not examined the bases on which either intracompany or intercompany charges have been set*

It is not clear from this assessment whether the access provider has established fair prices for the services it provides itself or whether it simply allocates a proportion of its total freight revenue for the purpose of regulatory accounting requirements on the basis of relevant accounting metrics.

In order to ensure internal access charges are being maintained Aurizon recommends that the compliance and reporting arrangements to the Commission be modified to include an obligation for the access provider to include in the report the internal access charges for rail services provided by related parties and the total rail freight rate associated with those services.

In addition, Aurizon recommends that the Information Kit be amended to include an obligation that the "likely price' includes the internal access charge for the same or similar services.

Summary of Recommendations

In summary, Aurizon recommends the following amendments be made to the Information Kit to better align to, and promote the objectives, of the ROA Act:

1. The Information Kit should include line diagrams which reasonably represent the scope and coverage of the SARAR;
2. The Information Kit should include additional guiding principles which includes reference to a ceiling price which represents the highest price which can be fairly asked taking into account the ability for an efficient rail operator to trade profitably in the rail haulage market on a sustained basis; and
3. The Information Kit include the requirement:
   - 3.1 to maintain and report to ESCOSA on the price of access to a related operator; and
   - 3.2 for the likely price to be given to an access seeker to reflect the relevant price to the related rail operator for the same or similar service.

[8] KPMG (2015) Review of GWA Financial Allocations, A report prepared for ESCOSA, July, pp. 1-2.